VZCZCXYZ0002
RR RUEHWEB

DE RUEHMU #2051/01 2612143
ZNR UUUUU ZZH (CCY ADX25FAEC MSI7778 640A)
R 182143Z SEP 06
FM AMEMBASSY MANAGUA
TO RUEHC/SECSTATE WASHDC 7601
INFO RUCPDOC/DEPT OF COMMERCE WASHINGTON DC
RHEBAAA/DEPT OF ENERGY WASHINGTON DC

UNCLAS MANAGUA 002051

SIPDIS

C O R R E C T E D COPY (CLASS MISMATCH)

SENSITIVE
SIPDIS

COMMERCE FOR ITA/MSIEGELMAN

DEPT PLEASE PASS TO WHA/CEN/GSCHIFFER, EB/ESC
DEPT PLEASE PASS TO USTDA/KMALONEY

E.O. 12958: N/A
TAGS: ENRG ECON PGOV NU
SUBJECT: NICARAGUA: THE OTHER POWER CRISIS

REF: A. 05 MANAGUA 2551

¶B. 06 MANAGUA 1079

¶1. (U) Summary: For the past four weeks the power sector in Nicaragua has been locked in crisis. At the center of the maelstrom is the electricity distributor,s inability to pay its power producers. With national elections only months away, resultant blackouts have taken on an important political dimension. As a short term solution to keep the system afloat, President Bolanos sought the injection of $9 million by paying the distributor for the low-end user subsidies set out in last year,s emergency energy legislation. This solution was thwarted, however, when the Liberal Constitutional Party (PLC) and the Sandinista Front (FSLN) refused to deliver the quorum required to consider the budget adjustment in the National Assembly. Everyone has a theory as to the root of the crisis, but the scapegoat of convenience has been Spanish owned electricity distributor Union Fenosa. However, the problems of the nation,s power sector go much deeper. The Instituto Nacional de Energia (INE), the regulatory agency, requires assistance in developing a more workable pricing formula and a realistic vision for meeting the nation,s growing demand. End Comment and Summary.

Power Sector in Crisis

¶2. (U) For the past four weeks, the power sector in Nicaragua has been locked in crisis. Rolling blackouts have affected virtually the entire country; in some sections of Managua, blackouts have totaled seven hours or more per day. Disgruntled consumers have marched on Union Fenosa, the nation,s primary electricity distributor. Demonstrations have been staged in Managua and Leon, leading to tire burnings and short-lived invasions of Union Fenosa,s offices. Power producers have threatened to close down

operations because of non-payment. In August, INE Chief Regulator (for energy) David Castillo cried foul, accusing power producers of pushing the system to the brink in an effort to force INE to revise its pricing policies. Shortly thereafter, Castillo launched public attacks on Union Fenosa for violating the terms of its contract. On its own initiative, the Comptroller General reviewed Union Fenosa,s contract, declaring it null and void. (Note: It is not clear that the Comptroller General has the authority to cancel INE,s contract with Union Fenosa.)

Election Year Politics

¶3. (SBU) It did not take long for the matter to take on a political dimension, with Sandinista observers declaring that the blackouts represented yet another example of the failure of market economics to deliver needed services to the poor, and clamoring for the return of the power sector to state ownership. FSLN presidential candidate Daniel Ortega continued to trumpet President Hugo Chavez, long standing offer to supply Nicaragua with cheap oil, criticizing the government for not allowing a company hastily composed of FSLN mayors to import fuel. (Comment: Ostensibly, the mayors would sell the oil to power producers or to the local refinery to produce gasoline or fuel oil at a reduced price, but how the savings would be passed along to the man in the street is unclear. What is clear is that the scheme would deliver cash to FSLN mayors, who could then spend it on what they liked, including turning out the FSLN vote on November 5.) Presidential candidate Eduardo Montealegre trumpeted conservation as a possible short-term solution, taking out a full-page newspaper ad to propose that long life light bulbs be given to anyone with a lamp, saving up to an estimated 30MW. The Spanish Chamber of Commerce, seeking to protect one of its leading members (i.e., Union Fenosa), called on PLC presidential candidate Jose Rizo to mediate. Rizo said he would talk to PLC member and INE Chief Castillo and others, but was otherwise non-committal. Edmundo Jarquin also spoke out, decrying what he termed the &politicization of INE.8

$9 Million Price Tag

¶4. (SBU) To keep the system afloat, President Enrique Bolanos proposed early on that the government inject $9 million into Union Fenosa under the terms of last fall,s emergency energy legislation. However, when the day came on September 6 in the National Assembly to consider his proposal, the PLC and

FSLN refused to deliver the quorum required to consider the adjustment to the budget. The government will try again the week of September 18. Empresa Nacional de Electricidad President Frank Kelly informed Emboff that the government was also working on a special loan from Banco CentroAmericano de Integracion Economica (BCIE), in the belief that the $9 million budget supplement would not be passed.

¶5. (U) The logic of the $9 million payment stems from INE,s mandate that all customers consuming fewer than 150 kwh per month receive electricity free of charge) and two out of every three customers fit into this category. This requirement places an even greater burden on the nation,s paying customers should the government fail to subsidize Union Fenosa for providing free services. In August, Union Fenosa estimated that the government owed the company $18 million, though it agreed to an injection of $9 million to hold the power sector together at least until national elections could be held on November 5. However, the situation for the power sector in mid September has become measurably worse. (Note: The government has injected cash into Union Fenosa before. In 2005, for example, it injected more than $5 million rather than accede to Union Fenosa,s request to raise electricity rates.)

The Root of the Crisis

¶6. (U) At this point, everyone has floated a theory as to the root of the crisis, but the scapegoat of choice has been Spanish owned electricity distributor Union Fenosa, the government,s contracted electricity distributor since privatization in 2000. Former PLC legislator and INE Chief David Castillo has repeatedly criticized Union Fenosa in the press for violating the terms of its contract, calling for arbitration and naming the firebrand leader of a local consumer organization as one of three arbiters to hear the case. Union Fenosa has not formally agreed to arbitration, although its contract does allow for it and the company has reportedly refused INE,s choice for an arbiter.

¶7. (U) While the problems of the nation,s power sector may converge on Union Fenosa, they go much deeper. The sector as a whole is extremely fragile, limiting the options that Union Fenosa has when parts of the system fail. The vast majority of the power, almost 80%, is generated from heavy oil or diesel. Ever-rising oil prices coupled with rising local demand and legal restraints have scarcely given the sector a chance to breathe since being privatized in 2001-02. Compounding the problem this year has been low rainfall along the river basin that fills Lake Apanas, the reservoir behind the country,s largest hydroelectric plant. Upon entry, Union Fenosa invested in improving collections and preventing theft, but was unable to meet its targets. In addition, the company has been unable to make headway on the 28% loss of power in the distribution system (as opposed to 14% in the countries like the United States). The rate of loss is due to theft, inefficiencies, and the fact that the company is prevented by law from upgrading its power lines to higher voltages, where greater efficiencies lie. These voltages are reserved for the state owned transmission company, ENTRESA.

¶8. (U) Recently, both the American Chamber of Commerce and the business federation COSEP publicly identified the root of the crisis as the failure of INE,s pricing formula to generate the cash flow needed to keep the system going. The formula is simply not responsive enough to constant price hikes, and there is no compensation fund available to smooth out oil price movements. Between December 2005 and June 2006, the average cost of generating a megawatt hour increased from $92.15 to $112.70. Prices to the consumer have also risen, but not enough to compensate for the rise in oil prices and with a lag time of about 45 days. The result has been that Union Fenosa has had increasing difficulty in paying power producers for the electricity they generate. Compounding matters is the emergency requirement introduced by INE in May 2005 that has limited power producer profit margins to 10% -- at once withdrawing the incentive producers needed to invest in more power at a time that demand was rapidly approaching supply and raising the risk of investing in Nicaragua. Additionally, INE has fined Union Fenosa millions of dollars for power cuts to consumers over the past six months.

¶9. (U) The inability of Union Fenosa to pay on time has created tremendous cash flow difficulties for power producers. Diminishing working capital has made it difficult for them to afford next month,s fuel bill and pay for maintenance. Many plants are 20 years old or more and need constant attention. Technical failures at three plants triggered the crisis when they shut down, removing as much as 100 MW from the grid.

How Bad Is It?

¶10. (SBU) Econoff learned from a major power producer that Union Fenosa,s top management in Spain is willing to walk away from the whole mess in Nicaragua if things get any worse. Clearly, the working environment for the company in Nicaragua has reached a new low. Union Fenosa reports that collection rates have dropped precipitously, as customers refuse to pay for service they are not receiving. A recent poll indicated that 82% of the population supported returning the sector to state control.

¶11. (SBU) This same power producer met with Union Fenosa to discuss the prospect of exercising a clause in its power supply contract that allowed it to hand over its plant should Union Fenosa fail to pay. The contract stipulated a pre-determined value until September 1, 2006; afterward, the power plant would have to be reappraised. The producer believed that after September 1, the value would be much lower, given the risk of not getting paid. In the end, Union Fenosa paid the company two-thirds of its arrears for June and the company stayed past September 1, in hopes that the government would inject $9 million cash into the system on September 6. When this did not happen, the company slipped effectively into the red. Managers told Econoff that they are now looking to shut down the plant at the earliest opportunity &to stop the bleeding.8

Crisis Management

¶12. (U) At the height of the crisis, Union Fenosa had a tough time soliciting electricity imports from its neighbors to stabilize the situation. For one, other Central American countries have also been trying to meet increased demand in a world with CAFTA. For another, Union Fenosa had to convince them that it could pay. Union Fenosa finally arranged for 30MW or more additional supply from El Salvador and Guatemala -- and reportedly with Costa Rica -- on the spot market. This has brought some stability to Nicaragua,s power sector as long as good neighborliness holds. For a while Union Fenosa was able to manage power outages in Managua by rolling four hours of down time a day through different sections of the city. When the Geosa power plant dropped its output from 113 MW to 25 MW on September 8, Union Fenosa increased rolling blackouts in Managua to 7-8 hours a day. Around the country, individuals and businesses who can afford it have been buying generators and fuel oil to produce their own electricity to keep their operations going.

COMMENT: What Needs to Be Done?

¶13. (SBU) Nicaragua,s power sector needs life support to keep the sector operating and out of the political fray during this election year. This can only come in the form of a sizeable cash injection into the system, such as the one proposed by President Bolanos. Cash would allow Union Fenosa to pay power producers and keep the lights on in Managua. If Bolanos fails to get the money from the National Assembly or Central American Bank for Economic Integration, the Nicaragua,s power sector could collapse, forcing the government at great expense to pick up the pieces, much as in the Dominican Republic when Union Fenosa walked from that market.

¶14. (SBU) Once life support is set in motion, INE needs to check itself in for long-term rehabilitation. Government needs to rethink legal changes in 2004 that transferred INE from the executive to the legislative branch, thus politicizing the agency. Regulators need to better understand the sector, employ a pricing system that is responsive to rising fuel prices, and pursue a workable vision for meeting growing demand and fueling development. Laws governing the power sector should be modified to allow for greater flexibility on the part of the distributor vis-a-vis the role of the transmission company. We are expecting the visit of an AID energy expert to review options with the government and INE in the near future.

¶15. (SBU) The InterAmerican Development Bank informed us that the INE recently requested advisory assistance. We should strongly support granting INE assistance from any credible source that can counsel INE on best practices, help INE develop a more workable pricing formula, and encourage INE to pursue a realistic vision for meeting the nation,s growing demand.
TRIVELLI